

## **APPENDIX A – AUDIT REPORT**

*Puerto Rico Telephone Company  
(SAC Number: 633201)*

*Performance audit for the Universal Service Fund  
disbursements made during the twelve-month period  
ended June 30, 2007*

Prepared for: Universal Service Administrative Company

As of Date: June 10, 2010

KPMG LLP  
2001 M Street NW  
Washington, DC 20036

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## EXECUTIVE SUMMARY

June 10, 2010

Mr. Wayne Scott, Vice President – Internal Audit Division  
Universal Service Administrative Company  
2000 L Street, N.W., Suite 200  
Washington, DC 20036

Dear Mr. Scott:

This report presents the results of our work conducted to address the performance audit objectives relative to the Puerto Rico Telephone Company, Study Area Code (“SAC”) No. 633201, (“PRTC” or “Beneficiary”) for disbursements, of \$17,109,394, made from the Universal Service Fund (“USF”) during the twelve-month period ended June 30, 2007. Our work was performed during the period from November 2, 2009 to June 10, 2010 and our results are as of June 10, 2010.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objective of this performance audit was to evaluate the Beneficiary’s compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the Federal Communications Commission’s (“FCC”) Rules as well as FCC Orders governing Universal Service Support for the High Cost Program (“HCP”) relative to disbursements, of \$17,109,394, made from the USF during the twelve-month period ended June 30, 2007.

As our report further describes, KPMG identified the following as a result of the work performed:

1. **HC-2009-FL041-F01: Lack of Continuing Property Record (“CPR”) Details** – The Beneficiary did not maintain CPRs, as of December 31, 2004, in sufficient detail for the following accounts:
  - General Support Facilities (Account 2110)
  - Central Office Switching Equipment (Account 2210)
  - Central Office Transmission Equipment (Account 2230)
  - Cable and Wire Facilities (Account 2410)

This asset detail is critical as Interstate Common Line Support (“ICLS”) disbursements for the twelve-month period ended June 30, 2007 are based on underlying financial data from calendar year 2004. KPMG performed alternative testing procedures to assess the reasonableness of these asset balances. However, the lack of sufficient financial records for capitalized assets impairs the Beneficiary’s



ability to readily identify the associated historical cost and accumulated depreciation when assets are sold, scrapped or otherwise retired. There is no monetary impact of the finding on the high cost disbursements received by the Beneficiary during the twelve-month period ended June 30, 2007.

2. **HC-2009-FL041-F02: Unsupported or Partially Supported Assets** – KPMG selected a statistical sample of assets in service as of December 31, 2004 for testing. The Beneficiary was unable to provide sufficient supporting documentation for 19 of the 40 assets selected for testing. In addition, the Beneficiary was only able to provide partial support for 7 of the 40 assets selected for testing. This resulted in a potential overstatement of USF disbursements of \$572,168, as the amounts originally reported could not be supported.

Based on the above results, we estimate that disbursements made to the Beneficiary from the USF for the HCP for the twelve-month period ended June 30, 2007 were potentially overstated by \$572,168 as the amounts originally reported could not be supported.

This performance audit did not constitute an audit of financial statements in accordance with *Government Auditing Standards*. KPMG was not engaged to, and did not render an opinion on the Beneficiary's internal controls over financial reporting or over financial management systems (for purposes of OMB's Circular No. A-127, *Financial Management Systems*, July 23, 1993, as revised). KPMG cautions that projecting the results of our evaluation to future periods is subject to the risks that controls may become inadequate because of changes in conditions or because compliance with controls may deteriorate.

Sincerely,

**KPMG LLP**

### **List of Acronyms**

<b>Acronym</b>	<b>Definition</b>
ARMIS	Automated Reporting and Management Information System
C&WF	Cable and Wire Facilities
CAM	Cost Allocation Manual
CLEC	Competitive Local Exchange Carrier
COE	Central Office Equipment
CPRs	Continuing Property Records
FCC	Federal Communications Commission
Form 508	Interstate Common Line Support Mechanism Projected Annual Common Line Revenue Requirement Form
Form 509	Interstate Common Line Support Mechanism Annual Common Line Actual Cost Data Collection Form
G/L	General Ledger
HCL	High Cost Loop
HCL Form	National Exchange Carrier Association Universal Service Fund Data Collection Form
HCP	High Cost Program
HCM	High Cost Model
IAS	Interstate Access Support
ICLS	Interstate Common Line Support
LSS	Local Switching Support
LSS Form	Local Switching Support Data Collection Form – True-up
NECA	National Exchange Carrier Association
PRTC	Puerto Rico Telephone Company
SAC	Study Area Code
SLC	Subscriber Line Charge
SNA	Safety Net Additive
SVS	Safety Valve Support
TRB	Puerto Rico Telecommunication Regulatory Board
TPIS	Telecommunications Plant In Service
USAC	Universal Service Administrative Company
USF	Universal Service Fund

## **BACKGROUND**

### **Program Overview**

USAC is an independent not-for-profit corporation that operates under the direction of the FCC pursuant to 47 C.F.R. Part 54. The purpose of USAC is to administer the USF through four support mechanisms: High Cost; Low Income; Rural Health Care; and Schools and Libraries. These four support mechanisms ensure that all people regardless of location or income level have affordable access to telecommunications and information services. USAC is the neutral administrator of the USF and may not make policy, interpret regulations or advocate regarding any matter of universal service policy.

The High Cost Support Mechanism, also known as the HCP, ensures that consumers in all regions of the nation have access to and pay rates for telecommunications services that are reasonably comparable to those services provided and rates paid in urban areas, regardless of location or economic strata. Thus, the HCP provides support for telecommunications companies (Beneficiaries) that offer services to consumers in less-populated areas. The HCP consists of the following support mechanisms:

1. HCL: HCL support is available for rural companies operating in service areas where the cost to provide service exceeds 115% of the national average cost per line. HCL support includes the following two sub-components:
  - a. SNA: SNA support is available for carriers that make significant investment in rural infrastructure in years when HCL support is capped and is intended to provide carriers with additional incentives to invest in their networks.
  - b. SVS: SVS support is available to rural carriers that acquire high cost exchanges and make substantial post-transaction investments to enhance network infrastructure.
2. HCM: HCM support is available to carriers serving wire centers in certain states where the forward-looking costs to provide service exceed the national benchmark.
3. LSS: LSS is available to rural incumbent carriers serving 50,000 or fewer lines and is designed to help carriers recoup some of the high fixed switching costs of providing service to fewer customers.
4. ICLS: ICLS is available to rate-of-return incumbent carriers and competitive carriers, and is designed to help carriers offset interstate access charges and to permit each rate-of-return carrier to recover its common line revenue requirement, while ensuring that its SLCs remain affordable to its customers.
5. IAS: IAS is available to price-cap incumbent carriers and competitive carriers, and is designed to offset interstate access charges for price cap carriers.

USAC engaged KPMG to perform a performance audit relating to the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the FCC's Rules as well as FCC Orders governing Universal Service Support for the HCP relative to disbursements, of \$17,109,394, made from the USF during the twelve-month period ended June 30, 2007.

### **Beneficiary Overview**

Puerto Rico Telephone Company (SAC No. 633201), the subject of this performance audit, is an ILEC, Non-Rural, Cost Company with competition in its study area and received ICLS support for the twelve-month period ended June 30, 2007. The Beneficiary is headquartered in Guaynabo, Puerto Rico, and is subject to regulation by the TRB with respect to intrastate services and the FCC with respect to interstate services. The Beneficiary was owned by Verizon Communications prior to its purchase by América Móvil on March 30, 2007. The Beneficiary is the largest Puerto Rican telecommunications services

company, providing voice, data, long distance, broadband, directory publishing and wireless services to the island residents and businesses.

The Beneficiary is affiliated with PRTC – Central Zone, SAC No. 633200, and PRTC d/b/a Verizon Wireless (re-branded as Claro after the acquisition by América Móvil), SAC No. 639006, all of which are study areas of Puerto Rico Telephone Company, Inc., a subsidiary of Telecomunicaciones de Puerto Rico, Inc. (“TELPRI”). The Beneficiary, along with PRTC – Central Zone, represents the wireline operations, while Verizon accounts for the wireless operations. The three study areas provide both regulated and non-regulated communications service in Puerto Rico, but operate individually as three separate SACs.

The following table illustrates the High Cost support (ICLS only) disbursed by USAC to the Beneficiary for each quarter during the twelve-month period ended June 30, 2007:

Quarter Ended	Total Disbursements
September 30, 2006	\$2,695,953
December 31, 2006	\$2,695,953
March 31, 2007	\$6,582,243
June 30, 2007	\$5,135,245
<b>Total</b>	<b>\$17,109,394</b>

*Source: USAC*

#### **Performance Audit Approach**

The High Cost support received by the Beneficiary during the twelve-month period ended June 30, 2007, was based on the following annual financial and operational data submitted by the Beneficiary to NECA and USAC:

- 2004 FCC Form 509, based on calendar year 2004 data
- 2006/2007 FCC Form 508, based on projected financial data for the program year beginning July 1 through June 30

These Forms capture the totals of certain pre-designated G/L Accounts including all asset accounts that roll into the TPIS account as well as certain deferred liabilities and operating expenses, subject to the allocation between regulated and non-regulated activities (Part 64 Cost Allocations), the separation between interstate and intrastate operations (Part 36 Cost Separations) and the separation between access and non-access elements (Part 69 Cost Separations). In addition, the Beneficiary is required to submit certain annual investment data, including the categorization of COE and C&WF on the USF Forms.

USAC has engaged KPMG to perform a performance audit of the Beneficiary’s compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the FCC’s Rules as well as FCC Orders governing Universal Service Support for the HCP relative to disbursements, of \$17,109,394, made from the USF during the twelve-month period ended June 30, 2007.

Through discussions with the Beneficiary, KPMG noted that a CAM Audit was performed on the Beneficiary for the year ended December 31, 2004 pursuant to 47 C.F.R. § 64.904(c). Such audit of the Beneficiary’s ARMIS Report 43-03, Joint Cost Report, was conducted to determine whether the Report 43-03 presented fairly, in all material respects, financial information as required by the FCC’s Joint Cost Orders issued in conjunction with CC Docket No. 86–111, the FCC’s Accounting Safeguards proceeding

in CC Docket No. 96-150, and the FCC's Rules and Regulations including 47 C.F.R. § 32.23, 32.27, 64.901 and 64.903 in force as of December 31, 2004. The CAM Audit covered the following areas:

- Part 32 balances of telecommunications plant assets, asset-related accounts, and operating expenses
- Part 64 Cost Allocation methodologies and underlying cost apportionment studies supporting the allocations of costs to regulated and non-regulated activities
- Transactions between affiliated entities
- Time reporting methodologies and underlying studies supporting payroll distributions

As the above areas were addressed by the previous CAM audit, USAC determined that such areas would be out-of-scope for the current performance audit.

## **OBJECTIVES, SCOPE AND METHODOLOGY**

### **Objectives**

The objective of this performance audit was to evaluate the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the FCC's Rules as well as FCC Orders governing Universal Service Support for the HCP relative to disbursements of, \$17,109,394, made from the USF during the twelve-month period ended June 30, 2007.

### **Scope**

The scope of this performance audit includes, but is not limited to, reviewing USF Forms or other correspondence and supporting documentation provided by the Beneficiary, assessing the methodology used to prepare or support the USF Forms or other correspondence, and evaluating disbursement amounts made or potentially due based on filings of USF Forms or other correspondence relative to disbursements made from the USF during the twelve-month period ended June 30, 2007. To the extent required, our procedures were extended to activities of the Beneficiary's affiliates and other related-parties to obtain sufficient information upon which to make our assessment.

KPMG identified the following areas of focus for this performance audit based upon our risk assessment:

1. Materiality Analysis
2. Reconciliation
3. Assets
4. COE Categorization
5. C&WF Categorization
6. Expenses
7. Overheads
8. Taxes
9. Part 36 and 69 Separations
10. Revenues
11. ICLS Projections

### **Methodology**

This performance audit includes procedures related to the ICLS mechanism for which funds were received by the Beneficiary during the disbursement period July 1, 2006 through June 30, 2007. The procedures performed during this performance audit include an analysis of the following:

1. Prior period engagements (e.g., audits, studies, etc.) that are significant within the context of the current audit objectives related to assessing risk, determining the nature, timing and extent of current audit work, and evaluating corrective actions taken to address findings and recommendations,

2. Material accounts included in the 2004 Form 509 selected for sample testing in the Asset<sup>1</sup> and Expense<sup>2</sup> test procedures,
3. Reconciliation from the audited financial statements to the G/L, the G/L to the Part 64 cost allocation inputs, the Part 64 cost allocation outputs to the Part 36 separations inputs, the Part 36 separations outputs to the Part 69 separations inputs, and the Part 69 separations inputs to the Form 509,
4. Framework and approach established by the Beneficiary to support the CPRs from 2004,
5. Asset balances and categorization to evaluate the reasonableness of the asset valuation, underlying G/L balances of assets and asset-related accounts, and classification and categorization of assets,
6. Methodologies and procedures used to perform the COE and C&WF asset categorizations,
7. Expense balances and categorization to determine the reasonableness of the expense reporting process in 2004,
8. Overhead distribution component of the operating expenses and plant assets,
9. Tax expense and related asset and liability balances in specific tax accounts recorded in the G/L,
10. Part 36 and 69 Separations methodologies including the appropriateness of allocation factors, evaluation of data sources and the frequency of the updates to the cost apportionment studies,
11. Revenues reported on the Form 509,
12. ICLS Projections reported on the Form 508.

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<sup>1</sup> KPMG used a stratified random sampling methodology to select 40 asset samples from the material accounts identified in the 2004 Form 509. In total, KPMG created twelve strata. Stratum one consisted of the six items with the highest dollar amounts, and stratum two consisted of the remaining items. Strata three, five, seven, and nine consisted of the five items with the highest dollar amount for accounts 2110, 2210, 2230, and 2410, respectively. Stratum four, six, eight, and ten consisted of the remaining items for those account numbers, respectively. Stratum 11 consisted of one item with the highest dollar amount, and the remaining three items were placed into stratum 12. Strata one, three, five, seven, nine, and eleven were sampled at 100%.

<sup>2</sup> KPMG selected a sample of 68 expense transactions from 2004 from the material accounts identified in the 2004 Form 509. In total, KPMG created nine strata. The expense items were first stratified by month, then by dollar amount, with a total of three strata per month. For each stratum, the sample was determined by selecting expenses associated with the first  $n$  random numbers for each stratum, where  $n$  was the sample size for that stratum.

## RESULTS

KPMG's performance audit results include a listing of significant findings, recommendations and management's responses with respect to the Beneficiary's compliance with FCC requirements, and an estimate of the monetary impact of such findings relative to 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, applicable to the disbursements made from the USF during the twelve-month period ended June 30, 2007. KPMG also noted other matters that we have reported to the management of the Beneficiary in a separate letter dated June 10, 2010.

### Findings, Recommendations and Beneficiary Responses

KPMG's performance audit procedures identified two significant findings. The findings along with the criteria, cause, effect, recommendation, and the Beneficiary response are as follows:

#### 1. HC-2009-FL041-F01: Lack of CPR Details:

<b>Condition</b>	The Beneficiary did not maintain CPRs, as of December 31, 2004, in sufficient detail for the following accounts:
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- General Support Facilities (Account 2110)
- COE -- Switching (Account 2210)
- COE -- Transmission (Account 2230)
- C&WF (Account 2410)

<b>Criteria</b>	According to 47 C.F.R. § 32.12(b), "The company's financial records shall be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts. The detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission."
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In addition, according to 47 C.F.R. § 54.202(e), "All eligible telecommunications carriers shall retain all records required to demonstrate to auditors that the support received was consistent with the universal service high-cost program rules. These records should include the following: data supporting line count filings; historical customer records; fixed asset property accounting records; general ledgers; invoice copies for the purchase and maintenance of equipment; maintenance contracts for the upgrade or equipment; and any other relevant documentation. This documentation must be maintained for at least five years from the receipt of funding."

Also, according to 47 C.F.R. § 32.2000(e)(2), "The basic property records must be: (i) Subject to internal accounting controls, (ii) auditable, (iii) equal in the aggregate to the total investment reflected in the financial property control accounts as well as the total of the cost allocations supporting the determination of cost-of-service at any particular point in time, and (iv) maintained throughout the life of the property."

<b>Cause</b>	The Beneficiary did not have an effective process in place to retain CPRs in sufficient detail, including identification of the date assets were placed in service, location of the property and work order number.
<b>Effect</b>	There is no monetary impact on the high cost disbursements received by the Beneficiary during the twelve-month period ended June 30, 2007. KPMG performed alternative testing procedures to assess the reasonableness of the asset balances reported as of December 31, 2004 (refer to Finding HC-2009-FL041-F02 below). However, the lack of sufficient financial records for capitalized assets impairs the Beneficiary's ability to readily identify the associated historical cost and accumulated depreciation when assets are sold, scrapped or otherwise retired.
<b>Recommendation</b>	The Beneficiary should establish and follow an appropriate methodology to properly maintain CPRs in sufficient detail in accordance with applicable FCC Rules and Orders.
<b>Beneficiary Response</b>	Management recognizes that we did not retain a snapshot copy of the CPRs from 2004, which required the auditors to utilize alternative methods to test the asset values reported for 2004. The lack of a snapshot copy of any part of the 2004 CPRs was primarily due to the conversion of various accounting systems, including the General Ledger, to an updated platform. It is important to remember that the 47 CFR 54.202(e) requirements were not adopted and implemented by the FCC until several years after 2004. Management believes that we currently maintain CPRs in sufficient detail in accordance with applicable FCC Rules and Orders and we agree to retain copies of the CPRs to the extent required by applicable FCC Rules and Orders.

2. **HC-2009-FL041-F02: Unsupported or Partially Supported Assets:**

<b>Condition</b>	KPMG selected a statistical sample of assets in service as of December 31, 2004 for testing. The Beneficiary was unable to provide sufficient supporting documentation for 19 of the 40 assets selected for testing. In addition, the Beneficiary was only able to provide partial support for 7 of the 40 assets selected for testing.
<b>Criteria</b>	<p>According to 47 C.F.R. § 32.12(a) and (b), "The company's financial records shall be kept in accordance with generally accepted accounting principles to the extent permitted by this system of accounts. The company's financial records shall be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts."</p> <p>In addition, according to 47 C.F.R. § 54.202(e), "All eligible telecommunications carriers shall retain all records required to demonstrate to auditors that the support received was consistent with the universal service high-cost program rules. These records should include the following: data supporting line count filings; historical customer records; fixed asset property accounting records; general ledgers; invoice copies for the purchase and maintenance of equipment; maintenance contracts for the upgrade or</p>

equipment; and any other relevant documentation. This documentation must be maintained for at least five years from the receipt of funding."

In addition, according to 47 C.F.R. § 32.2000(e)(2), "The basic property records must be: (i) Subject to internal accounting controls, (ii) auditable, (iii) equal in the aggregate to the total investment reflected in the financial property control accounts as well as the total of the cost allocations supporting the determination of cost-of-service at any particular point in time, and (iv) maintained throughout the life of the property."

<b>Cause</b>	The Beneficiary did not have policies and procedures in place to ensure that appropriate records were retained to support the asset amounts, including underlying supporting documentation and updated CPRs in sufficient detail to facilitate compliance with the FCC's CPR requirements.
<b>Effect</b>	<p>KPMG notes that the exceptions identified above have an impact on ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:</p> <ul style="list-style-type: none"><li>• ICLS disbursements calculated in the 2004 data submission were potentially overstated by approximately \$572,168, as the amounts originally reported could not be supported.</li></ul>
<b>Recommendation</b>	The Beneficiary should develop an effective process to retain documentation supporting asset additions in accordance with 47 C.F.R: § 32.12(a) and (b) and 47 C.F.R. § 54.202(e).
<b>Beneficiary Response</b>	Management agrees that we were unable to provide 100% of the required supporting documentation for the asset samples tested by the auditors. We do not believe the company received more ICLS support than it should have, only that at this time we were unable to provide the required supporting documentation for the asset samples. It is important to remember that the 47 CFR 54.202(e) requirements were not adopted and implemented by the FCC until several years after 2004. If the company still operated under rate of return regulation, we would readily indicate our complete agreement with the recommendation. However, effective July 1, 2008 the company implemented Price Cap regulation and the amount of ICLS that is received no longer is affected by revenue requirement considerations. Accordingly, Management agrees to implement the auditor's recommendation, to the extent appropriate for a Price Cap company.

### **Conclusion**

KPMG's evaluation of the Beneficiary's compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, based on revised USF Forms or other correspondence identified expense and asset findings relative to the disbursements made from the USF during the twelve-month period ended June 30, 2007. Detailed information relative to the findings is described in the Findings, Recommendations and Beneficiary Responses section above.

KPMG evaluated the USF disbursements made based on earlier filings of USF Forms, as compared to those which would have been made based on the revised filings or other correspondence. KPMG notes the combined estimated monetary impact of these findings as follows:

<b>Disbursement Mechanism</b>	<b>Monetary Impact Overpayment</b>
ICLS	\$ 572,168
<b>Total Impact</b>	<b>\$572,168</b>

KPMG recommends that the Beneficiary evaluate its governance methodologies and document retention policies related to assets recorded on its balance sheet and expenses recorded on its income statement. KPMG notes the Beneficiary should establish a methodology to properly retain its CPRs in sufficient detail. In addition, KPMG notes the Beneficiary should enhance the process to retain documentation in support of the asset additions and expense transactions.

*Puerto Rico Telephone Company*  
*(SAC Number: 633201)*

*Letter to management in connection with the  
performance audit for the Universal Service Fund  
disbursements made during the twelve-month period  
ended June 30, 2007*

Prepared for: Universal Service Administrative Company

As of Date: June 10, 2010

KPMG LLP  
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Washington, DC 20036



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Puerto Rico Telephone Company  
1513 Roosevelt Avenue, 8<sup>th</sup> Floor  
Cappara Heights, PR 00920

June 10, 2010

Ladies and Gentlemen:

We have conducted a performance audit to evaluate Puerto Rico Telephone Company's, Study Area Code ("SAC") No. 633201, ("Beneficiary") compliance with the applicable requirements of 47 C.F.R. Part 54, Subparts C, D, and K, Part 36, Subpart F, and Part 32, Subpart B, of the Federal Communications Commission's ("FCC") Rules as well as FCC Orders governing Universal Service Support for the High Cost Program ("HCP") relative to disbursements, of \$17,109,394, made from the Universal Service Fund ("USF") during the twelve-month period ended June 30, 2007. Our work was performed during the period from November 2, 2009 to June 10, 2010 and our results are as of June 10, 2010.

During this performance audit we noted immaterial noncompliance that was not in our report dated June 10, 2010. These immaterial noncompliance items are presented for your consideration as comments and recommendations. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to result in improved compliance with the aforementioned requirements and are summarized, along with the views of management, in Attachment 1 of this letter. We did not conduct performance audit procedures over the views of management, and accordingly, we provide no conclusions over these views relative to our audit objective.

Our performance audit procedures are designed primarily to evaluate the Beneficiary's compliance with the aforementioned requirements, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This report is intended solely for the information and use of Puerto Rico Telephone Company's management and others within the organization, the Universal Service Administrative Company ("USAC") and the FCC, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

**KPMG LLP**

cc: USAC  
FCC

## **Attachment 1**

KPMG's performance audit procedures identified the following immaterial findings. The findings along with the criteria, cause, effect, recommendation and Beneficiary response are as follows:

### **1 HC-2009-FL041-C01: Lack of Support for Customer Services Expenses and Allowance for Funds Used During Construction ("AFUDC"):**

<b>Condition</b>	<p>The average regulated amounts used in the Part 36 Separations Study ("Part 36 Study"), which serves as the input for the calculation of the Common Line Revenue Requirement ("CLRR"), did not reconcile to the corresponding source documentation for Customer Services Expense (Account 6620). The Customer Services Expense amount of \$25,252,152 per the Part 36 Study was \$85,152 higher than the amount of \$25,167,000 included as the regulated balance in the 2004 FCC Report 43-03, the ARMIS Joint Cost Report ("FCC Report 43-03"). The Beneficiary was unable to explain the difference.</p> <p>Additionally, the Beneficiary was unable to support the AFUDC amount of \$894,304 used in the Part 36 Study.</p>
<b>Criteria</b>	<p>According to 47 C.F.R. § 32.12(b), "The company's financial records should be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts."</p> <p>In addition, according to 47 C.F.R. § 54.202(e), "All eligible telecommunications carriers shall retain all records required to demonstrate to auditors that the support received was consistent with the universal service high-cost program rules. These records should include the following: data supporting line count filings; historical customer records; fixed asset property accounting records; general ledgers; invoice copies for the purchase and maintenance of equipment; maintenance contracts for the upgrade or equipment; and any other relevant documentation. This documentation must be maintained for at least five years from the receipt of funding."</p>
<b>Cause</b>	<p>The Beneficiary did not have an effective process in place to retain documentation supporting the reporting of Customer Services Expenses and AFUDC.</p>
<b>Effect</b>	<p>The monetary impact of this finding relative to disbursements made from the USF for the twelve-month period ended June 30, 2007 was not calculated as the correct AFUDC amount could not be estimated.</p>
<b>Recommendation</b>	<p>The Beneficiary should develop an effective process to retain documentation in accordance with 47 C.F.R. § 32.12(b) and 47 C.F.R. § 54.202(e), to support Customer Services Expenses and AFUDC amounts that are used in the Part 36 Study.</p>
<b>Beneficiary Response</b>	<p>Management agrees that the Account 6620 difference is an error and that we were unable to locate the documentation to support the indicated</p>

AFUDC amount. It is important to remember that the 47 CFR 54.202(e) requirements were not adopted and implemented by the FCC until several years after 2004. If the company still operated under rate of return regulation, we would readily indicate our complete agreement with the recommendation. However, effective July 1, 2008 the company implemented Price Cap regulation and the amount of Interstate Common Line Support (ICLS) that is received no longer is affected by revenue requirement considerations. Accordingly, Management agrees to implement the auditor's recommendation, to the extent appropriate for a Price Cap company.

**2 HC-2009-FL041-C02: Incorrect End User Subscriber Line Charge ("SLC") Revenue:**

<b>Condition</b>	The End User Subscriber Line Charge Revenues reported on the 24 Month View Report and the 2004 FCC Form 509 were overstated by \$3,984 for December 2004.
<b>Criteria</b>	According to the Instructions for Form 509, 47 C.F.R. § 54.903(a)(1) – (4), the Beneficiary is required to submit data, including End User SLC Revenue, necessary to calculate ICLS, to USAC by the required date.
<b>Cause</b>	The Beneficiary did not have an effective process in place to retain documentation supporting the SLC Revenue reported on FCC Form 509.
<b>Effect</b>	<p>KPMG notes that the exception identified above has an impact on ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:</p> <ul style="list-style-type: none"> <li>• ICLS disbursements calculated in the 2004 data submission were approximately \$3,984 lower than they would have been had amounts been reported properly.</li> </ul>
<b>Recommendation</b>	The Beneficiary should enhance policies and procedures governing the reporting of SLC Revenue in accordance with 47 C.F.R. § 54.903(a)(1) – (4).
<b>Beneficiary Response</b>	Management agrees that an error of \$ 3,984 was apparently made in the reporting of SLC Revenue as reported by the auditor. Management agrees to evaluate how existing policies and procedures might be enhanced to minimize the risk of similar errors in the future.

**3 HC-2009-FL041-C03: Lack of Support for Freeze of Central Office Equipment ("COE") Categorization Factors:**

<b>Condition</b>	The Beneficiary was unable to provide documentation to support the communications to the FCC regarding its election to freeze the factors used to categorize COE assets.
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<b>Criteria</b>	<p>According to 47 C.F.R. § 32.12(b), "The company's financial records should be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts."</p> <p>In addition, according to 47 C.F.R. § 54.202(e), "All eligible telecommunications carriers shall retain all records required to demonstrate to auditors that the support received was consistent with the universal service high-cost program rules. These records should include the following: data supporting line count filings; historical customer records; fixed asset property accounting records; general ledgers; invoice copies for the purchase and maintenance of equipment; maintenance contracts for the upgrade of equipment; and any other relevant documentation. This documentation must be maintained for at least five years from the receipt of funding."</p>
<b>Cause</b>	The Beneficiary did not have an effective process in place to retain documentation supporting the communication of its election to freeze COE categorization factors to the FCC.
<b>Effect</b>	There is no monetary impact on the high cost disbursements received by the Beneficiary during the twelve-month period ended June 30, 2007. However, the lack of sufficient documentation impairs the Beneficiary's ability to readily support the factors used to categorize COE assets.
<b>Recommendation</b>	The Beneficiary should develop an effective process to retain documentation supporting its election to freeze the COE categorization factors in accordance with 47 C.F.R. § 32.12(b) and 47 C.F.R. § 54.202(e).
<b>Beneficiary Response</b>	Management recognizes that we were unable to provide documentation supporting communication to the FCC of the election to freeze the factors used to categorize the investment in COE assets. Management agrees with the spirit of the auditor recommendation and will develop a process to retain such documentation, to the extent possible. However, since we do not currently possess documentation of the original communication, it will not be possible to retain a copy of that documentation, unless we are able to obtain a replacement copy.

**4 HC-2009-FL041-C04: Unsupported Expense Samples:**

<b>Condition</b>	KPMG selected a statistical sample of expense transactions from 2004 for testing. The Beneficiary was unable to provide sufficient documentation to support 11 of the 68 expense items selected for testing.
<b>Criteria</b>	According to 47 C.F.R. § 32.12(a) and (b), "The company's financial records shall be kept in accordance with generally accepted accounting principles to the extent permitted by this system of accounts. The company's financial records shall be kept with sufficient particularity to show fully the facts pertaining to all entries in these accounts."

In addition, according to 47 C.F.R. § 54.202(e), "All eligible telecommunications carriers shall retain all records required to demonstrate to auditors that the support received was consistent with the universal service high-cost program rules. These records should include the following: data supporting line count filings; historical customer records; fixed asset property accounting records; general ledgers; invoice copies for the purchase and maintenance of equipment; maintenance contracts for the upgrade or equipment; and any other relevant documentation. This documentation must be maintained for at least five years from the receipt of funding."

**Cause** The Beneficiary does not have effective policies and procedures in place to ensure that appropriate records are retained to support expense amounts.

**Effect** KPMG notes that the exceptions identified above have an impact on ICLS disbursements. The monetary impact of this finding relative to disbursements made from the USF for the HCP for the twelve-month period ended June 30, 2007 is estimated as follows:

- ICLS disbursements calculated in the 2004 data submission were potentially overstated by approximately \$356, as the amounts originally reported could not be supported.

**Recommendation** The Beneficiary should develop an effective process to retain documentation supporting expense transactions in accordance with 47 C.F.R. § 32.12(a) and (b) and 47 C.F.R. § 54.202(e).

**Beneficiary Response** Management agrees that we were unable to provide 100% of the required supporting documentation for the expense samples tested by the auditors. We do not believe the company received more ICLS support than it should have, only that at this time we were unable to provide the required supporting documentation for the asset samples. It is important to remember that the 47 CFR 54.202(e) requirements were not adopted and implemented by the FCC until several years after 2004. If the company still operated under rate of return regulation, we would readily indicate our complete agreement with the recommendation. However, effective July 1, 2008 the company implemented Price Cap regulation and the amount of ICLS that is received no longer is affected by revenue requirement considerations. Accordingly, Management agrees to implement the auditor's recommendation, to the extent appropriate for a Price Cap company.

**USAC Management Response**

Date: June 30, 2010

Subject: Improper Payment Information Act (IPIA) Audit of the High Cost Program of  
Puerto Rico Telephone Company, HC-FL-041, Follow-up Audit to HC 2007-299

USAC management has reviewed the IPIA performance audit of Puerto Rico Telephone Company ("the Carrier"), SAC 633201. The audit firm KPMG LLP has issued recommendations in its follow-up audit report. Our response to the audit is as follows:

**Finding 1**

**Condition:**

The Beneficiary did not maintain CPRs, as of December 31, 2004, in sufficient detail for the following accounts:

- General Support Facilities (Account 2110)
- COE -- Switching (Account 2210)
- COE -- Transmission (Account 2230)
- C&WF (Account 2410)

**Management Response:**

USAC High Cost management concurs with the auditor. The Carrier does not have documentation consistent with Part 32 rules necessary to support account data reported in its filings with the National Exchange Carrier Association (NECA) and USAC.

USAC notes that the Carrier believes it has sufficient internal controls related to this finding, and requests that the Carrier provide a detailed update of specific controls no later than 60 days after receipt of this management response. (Please send to USAC High Cost at [hcaudits@usac.org](mailto:hcaudits@usac.org) when submitting this information.)

USAC notes that the auditor found no monetary effect so there is no recovery of funds required.

**Finding 2**

**Condition:**

KPMG selected a statistical sample of assets in service as of December 31, 2004 for testing. The Beneficiary was unable to provide sufficient supporting documentation for 19 of the 40 assets selected for testing. In addition, the Beneficiary was only able to provide partial support for 7 of the 40 assets selected for testing.

**Management Response:**

USAC High Cost management concurs with the auditor. The Carrier does not have documentation consistent with Part 32 rules necessary to support account data reported in its filings with the National Exchange Carrier Association (NECA) and USAC.

USAC acknowledges the Carrier converted to Price Cap regulation effective July 1, 2008; however, the period under audit preceded the conversion and documentation should have been maintained by the Carrier.

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of \$572,168.

**Comment 1**

**Condition:**

The average regulated amounts used in the Part 36 Separations Study ("Part 36 Study"), which serves as the input for the calculation of the Common Line Revenue Requirement ("CLRR"), did not reconcile to the corresponding source documentation for Customer Services Expense (Account 6620). The Customer Services Expense amount of \$25,252,152 per the Part 36 Study was \$85,152 higher than the amount of \$25,167,000 included as the regulated balance in the 2004 FCC Report 43-03, the ARMIS Joint Cost Report ("FCC Report 43-03"). The Beneficiary was unable to explain the difference.

Additionally, the Beneficiary was unable to support the AFUDC amount of \$894,304 used in the Part 36 Study.

**Management Response:**

USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC acknowledges the Carrier converted to Price Cap regulation effective July 1, 2008; however, the period under audit preceded the conversion and documentation should have been maintained by the Carrier. USAC notes that the auditor found no monetary effect so there is no recovery of funds required.

**Comment 2**

**Condition:**

The End User Subscriber Line Charge Revenues reported on the 24 Month View Report and the 2004 FCC Form 509 were overstated by \$3,984 for December 2004.

**Management Response:**

USAC High Cost management concurs with the auditor. Failure to submit accurate financial data may result in incorrect payments from the USF. It is the obligation of a carrier to ensure that it is providing accurate data consistent with FCC rules.

USAC recognizes that the Carrier committed to addressing its internal controls related to this comment, and requests that the Carrier provide a detailed update of specific corrective actions no later than 60 days after receipt of this management response. (Please send to USAC High Cost at [hcaudits@usac.org](mailto:hcaudits@usac.org) when submitting this information.)

**Comment 3**

**Condition:**

The Beneficiary was unable to provide documentation to support the communications to the FCC regarding its election to freeze the factors used to categorize COE assets.

**Management Response:**

USAC High Cost management concurs with the auditor. The Carrier does not have documentation consistent with Part 32 rules necessary to support account data reported in its filings with the National Exchange Carrier Association (NECA) and USAC.

USAC acknowledges the Carrier converted to Price Cap regulation effective July 1, 2008; however, the period under audit preceded the conversion and documentation should have been maintained by the Carrier. USAC notes that the auditor found no monetary effect so there is no recovery of funds required.

**Comment 4**

**Condition:**

KPMG selected a statistical sample of expense transactions from 2004 for testing. The Beneficiary was unable to provide sufficient documentation to support 11 of the 68 expense items selected for testing.

**Management Response:**

USAC High Cost management concurs with the auditor. The Carrier does not have documentation consistent with Part 32 rules necessary to support account data reported in its filings with the National Exchange Carrier Association (NECA) and USAC.

USAC acknowledges the Carrier converted to Price Cap regulation effective July 1, 2008; however, the period under audit preceded the conversion and documentation should have been maintained by the Carrier.

As directed by the FCC, USAC is obligated to implement all recommendations arising from the audits including recovery of funds that may have been improperly disbursed to beneficiaries. Therefore, USAC will recover High Cost support in the amount of \$356.

**Audit Recovery Total**

	ICLS
Finding 2	\$572,168
Comment 2	(3,984)
Comment 4	356
Total	<b>\$568,540</b>

This concludes the USAC management response to the audit.

## **APPENDIX B – USAC OCTOBER 5, 2010 LETTER**



By Certified Mail, Return Receipt Requested

October 5, 2010

Robert Figenschier  
Regulatory Accounting, Tariffs and Cost Separations Director  
Puerto Rico Telephone Company  
1513 Roosevelt Avenue  
8th Floor  
Caparra Heights, PR 00920

Re: Action to be Taken Resulting from High Cost Audit of Puerto Rico Telephone Company (SAC 633201) Audit Report HC-2009-FL-041, Follow-up Audit to HC-2007-299

Dear Bob Mouser:

A follow-up audit of Puerto Rico Telephone Company for Study Area Code (SAC) 633201 was conducted on behalf of the USAC Internal Audit Division (IAD) and the Federal Communications Commission (FCC) Office of Inspector General (OIG) for the period July 1, 2006 through June 30, 2007. The final report from that follow-up was sent to the company on September 28, 2010.

As is USAC's policy with adverse or disclaimer opinions, the follow-up audit was required to quantify the monetary effect of audit HC-2007-299 conducted by KPMG LLP. The effect quantified will result in a recovery of \$568,540 of Interstate Common Line Support for SAC 633201. Please refer to the audit report for details on the funds being recovered. USAC will recover these funds from your December 2010 High Cost support payment, which will be disbursed at the end of January 2011.

Consistent with current administrative practice, if the recovery amount exceeds the company's disbursement for that month, USAC will continue to offset the remaining recovery amount balance against subsequent High Cost support disbursements until such time as the full amount is recovered. If necessary, USAC reserves the right to invoice and collect any remaining amounts owed.

As is the case with any decision of the USF administrator, you have the right to appeal this decision directly to the FCC pursuant to 47 C.F.R. § 54.719. The appeal must be filed within 60 days of the date of this letter as required by 47 C.F.R. § 54.720(a) and must conform to the filing requirements of 47 C.F.R. § 54.721. Additional information about the FCC appeals process may be found at <http://www.usac.org/hc/about/filing-appeals.aspx> under "OPTION B."

Sincerely,

Craig Davis  
Director, High Cost

## **APPENDIX C – USAC SEPTEMBER 28, 2010 LETTER**



High Cost and Low Income Division

Certified Mail, Return Receipt Requested

September 28, 2010

RE: Results of the Follow-Up Audit to the 2007-2008 Federal Communications  
Commission (FCC) Office of the Inspector General (OIG) Audit

Dear Beneficiary:

Enclosed are the finalized report from, and the USAC High Cost Management Response to, the follow-up audit to your FCC OIG audit. Included in the High Cost Management Response may be directives required for the closure of audit findings and/or comments. Please complete any such follow-up measures and provide documentation of corrective actions to USAC High Cost within 60 days of receipt of this letter, if applicable.

As is the case with any administrative decision made by USAC, you have the right to appeal findings and/or comments within the audit and High Cost Management Response. You may appeal to USAC or the FCC, and the appeal must be filed within 60 days of receipt of this letter. Additional information about the appeals process may be found at <http://www.usac.org/hc/about/filing-appeals.aspx>.

If you have any questions, please contact the High Cost Program at 202-776-0200 or [hcaudits@usac.org](mailto:hcaudits@usac.org). Please direct all High Cost audit correspondence to either the e-mail address above or:

USAC  
Attn: HC Audits  
2000 L Street, NW  
Suite 200  
Washington, DC 20036

Sincerely,

*High Cost Program Management*

Enclosure: Final Audit Report

# **CERTIFICATE OF SERVICE**

I hereby certify that on this 6th day of December, 2010, I caused copies of the foregoing Request for Review By Puerto Rico Telephone Company of the Decision of the Universal Service Administrator to be served upon the following party by first-class mail:

Universal Service Administrative Company  
Attention: David Capozzi, Acting General Counsel  
2000 L Street, N.W., Suite 200  
Washington, DC 20036



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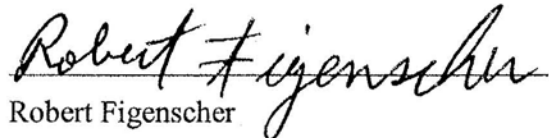
**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554**

In the Matter of	)	
	)	
Request for Review by Puerto Rico Telephone	)	WC Docket No. 08-71
Company of Decision of the Universal Service	)	
Administrator	)	
	)	
	)	

**DECLARATION OF ROBERT FIGENSCHER**

I, Robert Figenschcer, do hereby, under penalty of perjury, declare and state as follows:

1. I am the Director of Regulatory Accounting, Tariffs and Cost Separations for the Puerto Rico Telephone Company ("PRT"). In that capacity, I am familiar with the cost studies and related information that PRT has filed with the Universal Service Administrative Company ("USAC") and the National Exchange Carrier Association, Inc. ("NECA") in connection with federal universal service support. I also am familiar with the audit conducted on behalf of USAC regarding PRT's compliance with the requirements of the Federal High Cost Universal Service Program for the period from July 1, 2006 through June 30, 2007.
  
2. In accordance with Commission rules, 47 C.F.R. § 54.721(b), I have reviewed the factual assertions set forth in PRT's Petition for Review and hereby certify that such factual assertions are true and correct to the best of my knowledge.

  
Robert Figenschcer

Dated: December 6, 2010